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IN THE

Supreme Court of the United States

OCTOBER TERM, 1932.

No. 192.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE,

v.

ALUMINUM GOODS MANUFACTURING COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

MOTION FOR LEAVE TO FILE BRIEF AS AMICUS CURIAE, AND BRIEF.

WARD LOVELESS,
Amicus Curiae.

Washington, D. C.,
December, 1932.

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MAY IT PLEASE THE COURT:

The undersigned having first obtained the consent of both parties respectfully moves this Honorable Court for leave to file the accompanying brief as amicus curiae.

WARD LOVELESS,
Amicus Curiae.

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BRIEF OF WARD LOVELESS, AMICUS CURIAE.

This brief is submitted on behalf of clients whose tax liability might be affected by the result in one issue involved in this case. For brevity, formal matters covered in the briefs of the parties are not here repeated. This brief relates only to that one of the issues which affects clients of the undersigned.

Statement.

This case involves Federal excess profits taxes for the year 1917, and turns on whether a deductible loss is allowable for that year, because of the worthlessness of certain stock. The respondent, Aluminum Goods Manufacturing Company, purchased in 1914 all the capital stock of the

Aluminum Sales Company. In 1917, the Sales Company was liquidated. Its assets were less than its obligations, so that its stock thereupon became worthless in the hands of the respondent. The cost of the stock of the Sales Company was charged off the respondent's books as a loss by the close of 1917 (R. 11). No business of any kind was transacted by the Sales Company after 1917, and it was dissolved in February, 1918 (R. 13, 14). Under the tax laws applicable to 1917, corporation income taxes are to be calculated on the basis of separate returns, even though two corporations were so related as to satisfy the definition of "affiliation." But for excess profits tax purposes, two companies are to have their excess profits tax calculated on the basis of a consolidated return, if their relationship was within that definition. The respondent claimed the right to deduct the loss from its 1917 gross income both for income tax purposes (involving a separate return) and for excess profits tax purposes (involving a consolidated return). The Commissioner allowed it as a deduction for income tax purposes, but denied it as a deduction for excess profits tax purposes (R. 12). The Board of Tax Appeals sustained the Commissioner (R. 21); the Circuit Court of Appeals reversed the Board of Tax Appeals (R. 29); the propriety of that reversal is now before this Court.

Summary of Argument.

The Revenue Acts of 1916 and 1917 allow as deductions in computing net income losses actually sustained and charged off within the year, and Government regulations have consistently recognized that if property becomes worthless, the taxpayer does not have to sell it to get the deduction; in this case the stock became worthless in 1917, so that the deduction is within the terms of the statute and regulations.

If this worthless stock had been sold to an outsider for a nominal sum, no question could have been raised as to

the deductibility of the loss. There is no practical reason for a different result when stock becomes hopelessly worthless, but is not sold. The sale would be a useless gesture. It is unreasonable to suppose that Congress, having provided for losses generally, could have intended that taxpayers whose losses were suffered in this particular manner should fail to get any deduction benefit therefrom. The respondent having started a stock transaction in 1914 and closed it in 1917 by abandonment of the worthless stock, (when it charged it off) suffered a loss of precisely the type which Congress intended to be deducted.

A determination of worthlessness involves only one party—the owner—and hence cannot be an "intercompany" transaction. Even though worthlessness is *demonstrated* by some transaction, the worthlessness is an independent basis for the deduction.

Intercompany transactions are not referred to in the tax law. The Commissioner is without authority to establish a rule that all intercompany transactions are to be disregarded in a consolidated return. Regulations 41, governing the imposition of this tax, do not establish any such rule. Nor has the Commissioner power to invoke such a theory in order to make a distinction between the case where a worthless asset is sold for a nominal price and the case (in practical effect the same) where abandonment occurs without such sale.

Even if there were a rule that all intercompany transactions are to be disregarded, the rule would not apply in this case. Affiliation was broken when the subsidiary abandoned active business and liquidated.

There is no merit in the contention that a separate return is to be filed for a fractional part of a day following the liquidation of the subsidiary. Settled Government regulations are to the effect that no separate return is required for such small fractions of the taxable year. It is funda-

mental that the income of a taxpayer even though affiliated during the year with another taxpayer, is to be computed upon an annual basis. It is not reasonable to assume that Congress intended that a taxpayer which had suffered a real loss, should be deprived of the benefit of it by assigning it to a small separate period in which there could be no income to offset it.

Argument.

I.

The Loss Claimed by the Respondent Meets Every Statutory Requirement as a Deduction.

It is provided in Section 12(a) Second, Revenue Act of 1916, amended, that in computing net income there shall be deducted from gross income:

> "All losses actually sustained and charged off within the year * * *."

No one disputes that the Sales Company completely liquidated its assets within 1917 and that they were not sufficient to meet its obligations. Thereupon the stock of the Sales Company became worthless and the cost thereof was the measure of the loss to the respondent. The Commissioner's allowance of the loss for income tax purposes so adjudicates.

The question whether a taxpayer could have a loss in respect of an asset which had become absolutely worthless (without selling it) was early presented in the Bureau, and continuously for more than fifteen years the regulations have provided that sale was not necessary. See Article 178, Regulations 33; Article 173, Regulations 74. This kind of deductible loss was called in the Regulations "loss of useful value." These regulations recognized the fact that if worthless property—whether corporate stock or ma-

chinery or other assets—was sold to an outsider for a nominal sum, no question could possibly be raised as to the deductibility of the loss, and that the same practical result occurs when such property becomes hopelessly worthless and useless. To require sale in order to get the deduction would be to require a useless procedure.

The respondent started a venture in 1914 by purchasing the corporate stock of the subsidiary from third persons, and closed that venture in 1917, no part of the original cost being recovered. This is a loss of precisely the type which Congress intended to be deducted. It is unreasonable to suppose that Congress, having provided for losses generally, could have intended that a taxpayer situated as this one is should fail to get any deduction for his loss. It is clear that if no deduction is allowed for this loss in 1917, the taxpayer will never have a chance to take it as a deduction.

Where one corporation makes an investment by purchasing all the stock of another and after a number of years abandons the investment as a total loss, that loss is clearly deductible, under the specific language of the tax law, no matter what the *cause* of the diminution in value between purchase and disposition. The diminution in value of a stock so purchased for an investment might be due to an unrealized decline in value of its capital assets over a period during which it was held, or to the fact that it operated without being able to make a profit, or that its operations had shown an actual loss, or to other causes. The tax law does not operate differently as regards varying causes of the diminution in value of the stock. In those relatively rare cases where the diminution in value of the stock is due only to the fact that the corporation lost money, the deduction of the whole loss realized by the stockholder on disposition is nevertheless allowable. In other words, it does not matter whether the lessening in value of the stock was due to losses which had been realized by the corpora-

tion or to losses (such as diminution in the value of land) which involved unrealized shrinkage of value.

Petitioner's brief, page 21, appears erroneously to assume that a corporation which buys all the stock of another corporation and disposes of it at a loss in 1917 cannot use that loss as a deduction in 1917 if the subsidiary has claimed losses in the years 1914 to 1917, inclusive. Thus the petitioner's brief says (p. 21):

> "The losses actually incurred by the Sales Company in its operations during 1917 were allowed as deductions by the petitioner. This loss and losses of prior years were reflected in the depreciation of its stock and the exhaustion of its assets which rendered its debts uncollectible."

This argument is unsound because (1) it erroneously assumes that a corporation claiming a loss on 100 per cent-owned stock must diminish that loss by any losses the subsidiary has claimed while it was owned by that taxpayer (an assumption wholly without foundation; *United Publishers' Corporation v. Anderson*, 42 Fed. (2d) 781) and (2) it also assumes that the diminutions in value of the Sales Company stock between 1914 and 1917 are necessarily due to realized losses. If there were any such principle as that suggested in the petitioner's brief, then it is clear that the Commissioner would not have allowed this loss for income-tax purposes.

II.

The Doctrine of Intercompany Transactions is Immaterial Here Because Only One Party is Involved in a Determination of Worthlessness.

The Commissioner's reason for refusing to recognize the loss as deductible in computing consolidated net income for excess profits tax purposes (in spite of the fact that he held

it deductible in computing net income for the purpose of the corporation income tax) was that the liquidation "was an intercompany transaction."

This overlooks the fact that where a separate taxpayer or a taxpayer in a consolidated group determines that an asset is worthless (whether that asset is a machine or a corporate stock) during the taxable year, and charges it off, the loss deduction is allowable. Such a determination that a machine or a stock is worthless is not a transaction between two parties, but merely an act of the owner. The determination of worthlessness cannot be an intercompany transaction, since it is an act of only one party. Even though the Commissioner disregards the liquidation transaction, which *disclosed* worthlessness, there still remains the determination of worthlessness by the owner of the asset, and the owner is entitled to the deduction under the previously mentioned regulations regarding "loss of useful value."

III.

There is no Requirement in the Law That Every Intercompany Transaction is to be Disregarded.

Considering further the reason which the Commissioner gave for refusing to allow this loss—that the loss resulted from an intercompany transaction—it is here contended, first, that the Commissioner is without authority to establish a rule that all intercompany transactions, without exception, are to be disregarded in a consolidated return; and, second (see part IV of this brief), that even if it is assumed that the Commissioner has power to establish so broad a rule, this case does not come within it because, here, affiliation was terminated before the loss was realized.

It is significant that the term "intercompany transaction" does not appear anywhere in the statute. The Com-

missioner's reason for disallowing the deduction is not based on anything in the statute. Respondent does not dispute the propriety of eliminating certain types of transactions between affiliated companies in calculating consolidated net income. Some such elimination is undoubtedly proper in certain cases where such transactions would result in a deduction not intended by Congress. But whatever may be the notion of the administrative department or of the accounting profession as to the correct *definition* of eliminable intercompany transactions, such definition may be applied in determining consolidated net income only so far as it does not conflict with the purpose of the law as plainly expressed in its specific provisions. There is no reason to assume that Congress has given the Commissioner the power to disregard all intercompany transactions. If Congress had intended so simple and general a rule, undoubtedly such a provision would have appeared in the law.

Thus Regulations 41 relative to the war excess profits tax under the Revenue Act of 1917, Art. 77, provided merely that every corporation shall describe all intercorporate relationships with a view of "equitable and lawful accounting." Even these regulations do not provide that intercompany transactions shall be eliminated; in fact the term "intercompany transactions" does not appear even in the regulations having to do with the Revenue Act of 1917.

The Commissioner was plainly not warranted in invoking a mere theory that all intercompany transactions were to be disregarded in a case such as this where the effect of the application of that theory is to arrive at a curious distinction between the case of sale of a worthless asset, and its abandonment—a distinction which has generally been held unfounded. Neither the parent corporation nor the affiliated group would have been any better off if there had been the formality of a sale of the stock to an outside interest for a nominal consideration. The Commissioner is with-

out authority to create and apply a theory which makes an entirely illogical difference in the result between sale of worthless stock and mere abandonment of it.

Congress could not have intended to deprive holding companies of the loss sustained in a venture merely because the company liquidated the stock and found it worthless, instead of selling it to a third person for a nominal sum.

Petitioner's brief undertakes, at some length, to set forth the purpose of the requirement regarding consolidated returns for 1917. We submit that petitioner's assumptions in this regard are erroneous. The purpose may be stated plainly and briefly. It is to insure the imposition of the excess profits tax upon the basis of the true net income and true statutory invested capital of units of two or more corporations owned or controlled by the same interests and engaged in the same or closely related businesses. Thus, such corporations are prevented from circumventing the statutory provisions relating to separate corporations, by arbitrarily shifting items of income or deductions from one to the other through the medium of inter-corporate manipulation.

The primary purpose of the provisions for consolidated returns is not, as brief for the petitioner submits (p. 13), "to reflect accurately the true financial condition of a business enterprise by disregarding the corporate units which compose the whole." There is no authority for that statement. The taxing statute does not concern itself with "the true financial condition of a business enterprise," except as it may facilitate the determination of statutory net income and statutory invested capital. To argue otherwise merely confuses the issue.

On page 22 of petitioner's brief, he argues—

> "If, as the Circuit Court of Appeals holds, the losses in question may be deducted upon the consolidated return of the respondent and the Sales Company, it results that the excess-profits tax is to be computed upon

> the basis of the *separate* net income of the respondent but at rates determined by the use of the *consolidated* invested capital of both corporations. Such a result finds no sanction in law and contravenes the requirement of the statute that the excess-profits tax be determined on the basis of consolidated net income *and* invested capital. * * *"

We believe petitioner is in error in so stating. The result there mentioned is definitely sanctioned by the law and was actually reached in many cases. For instance, where one member of an affiliated and consolidated group has no net income and its affiliates have net income, the consolidated net income is taxed at a less excess profits tax rate because the invested capital of the group includes the invested capital of the no-income affiliate. In every case where one member of an affiliated and consolidated group has a net loss and its affiliates have net income, the consolidated net income is arrived at by offsetting the net loss against the sum of the other net incomes, and the consolidated invested capital is the sum of the separate invested capital of all the affiliated corporations. The result in such case is a definite diminution of the rate of excess profits tax as compared with the rate in case of separate returns. Petitioner is in error in assuming that there is anything unusual or inconsistent with the general plan of the law in the result arrived at by the Circuit Court of Appeals.

IV.

The Loss Occurred Outside the Period of Affiliation.

Even though the Commissioner had power to establish an absolute rule that all intercompany transactions of whatever kind are to be disregarded if they occur during the period of affiliation, the rule would not apply in this case. Affiliation was broken when the subsidiary abandoned active business and liquidated.

The definition of affiliation applicable to the year 1917 is much narrower than the statutory definition which applied to 1918 and subsequent years.

The Revenue Act of 1921, Section 1331, provided that, under the Revenue Act of 1917, a corporation was to be deemed affiliated with one or more other corporations "when such corporation * * * owned directly * * * all or substantially all the stock of the other or others * * *, *Provided,* that such corporations * * * were engaged in the same or a closely related business, * * *."

The petitioner in his brief failed to bring out that for the year 1917 more than mere stock ownership is required for affiliation. Later statutes with different provisions are not pertinent.

The provision above quoted plainly prescribes two requisites for affiliation, viz,—

(1) ownership of substantially all the stock and,
(2) engagement in the same or a closely related business.

One of these attributes is not sufficient.

No one disputes that the Sales Company discontinued its business in 1917 before liquidation and within that year completely liquidated its assets. It was not "engaged in the same or a closely related business" after it abandoned all business. When the subsidiary corporation ceased business within the year 1917 its engagement in "the same or a closely related business" as that of the respondent, at that moment it ceased to be affiliated with the respondent.

It is true that for a period the Commissioner had a practice (we contend an erroneous one) of holding that purchase from and sale to outside interests of the stock of a company, which after the purchase was affiliated, were both inter-company transactions. The Board of Tax Appeals agreed with that practice until the Circuit Court of Ap-

peals, for the Second Circuit, in *Remington Rand, Inc. v. Commissioner,* 33 Fed. (2d) 77 (cert. denied 280 U. S. 591), reversed that holding, saying at page 78:

> "Both the purchase and the sale took place outside the period of affiliation, and were made by the seller for its own account, not for the account of the affiliated group * * *."

The Tax Board now holds that a parent company realizes gain or loss upon the liquidation of a subsidiary.

Riggs National Bank v. Commissioner, 17 B. T. A. 615, affirmed (C. C. A.-4), 57 Fed. (2d) 980.
Canal-Commercial National Bank v. Commissioner, 22 B. T. A. 541.
Houghton & Dutton Company v. Commissioner, 26 B. T. A. ———.
Prosperity Company, Inc. v. Commissioner, 27 B. T. A. ———.

A similar conclusion was reached in *American Printing Company v. United States* (District of Massachusetts), 53 Fed. (2d) 98; and *Wilmington Steamboat Company v. Sturgess* (District of N. J.), 52 Fed. (2d) 210, affirmed 55 Fed. (2d) 831. The Tax Board and the courts have reached this conclusion under the theory that distributions in liquidation are equivalent to payments in exchange for stock. (*Hellmich v. Hellman,* 276 U. S. 233.)

The stockholder, having received all the assets, is no longer the beneficial owner of the stock it is exchanging for the assets, no matter who has possession of it. The liquidating corporation, after it has delivered its assets for its stock, is the real owner of its stock.

The only reason given by the United States Board of Tax Appeals for denying the loss claimed in the instant case was that "the petitioner continued to own all the Sales Company stock and filed a consolidated return * * *."

We submit that this reason is not sufficient. The distribution in liquidation and not the dissolution of the Sales Company determined the worthlessness of the stock. After distribution of assets there was a mere shell. It would be unreasonable to assume that Congress intended the deduction to depend on an unimportant circumstance—namely, whether dissolution was prompt or slow.

V.

No Separate Return is Required for the Small Fraction of a Year Following Liquidation.

On page 23 of petitioner's brief he argues that even if it is held that the loss was sustained outside the period of affiliation, it would be deductible only in computing the separate net income of the respondent in a return filed for the short period—apparently less than a day—between the time of liquidation of the subsidiary and the end of the year 1917. This would produce an entirely unreasonable result, and is contrary to the law and the regulations.

The tax is imposed upon the net income for the taxable year, determined in the manner prescribed by the statute. The taxable year is the calendar year, except in the case of a corporation allowed to fix its own fiscal year. The first taxable year is the year ended December 31, 1917 (Section 200 of the Revenue Act of 1917).

The Treasury Department's Regulations 41, Articles 77, 78, providing for 1917 consolidated returns, contemplated that the separate incomes and separate invested capital of the several affiliated taxpayers would be combined so that the affiliated group would represent merely a tax-computing unit and not a new taxpayer. Individual corporations in an affiliated group do not lose their status as taxpayers. (*Woolford Realty Company, Inc. v. Rose,* 286 U. S. 319).

The statute required the respondent and the Sales Company to make separate returns of their separate net in-

comes for the taxable period. The taxable period of respondent and the Sales Company was the calendar year 1917.

The excess profits tax for 1917 is imposed upon the consolidated net income of these corporations for the calendar year 1917. There is no authority in the statute nor any attempt in the Treasury Regulations to levy the tax upon any other basis or for any other period.

The argument in the petitioner's brief would brush aside and nullify the most fundamental principle underlying income taxation, namely, the periodic determination of income. The statute adopts the period of one year as the period for which every taxpayer's net income and tax thereon shall be determined.

The notion that the tax may be computed upon the basis of separate returns by the same taxpayer for separate portions of the same taxable year not only has no sanction in law but would conflict with the purpose of the statute. In the case of income taxes, little or no difference may result from the computation of the tax upon the basis of separate returns of net income for separate portions of the taxable period. Income taxes are fixed percentages of net income less certain credits and exemptions. This is not true of excess profits taxes, which are based upon net income but measured by varying rates according as the net income may exceed certain percentages of invested capital. To attempt to compute the tax on the basis of net income and invested capital (consolidated or of a separate corporation), determined separately for separate portions of the same taxable year, would not only produce illogical results, but would involve arithmetical problems of great complexity.

This question was before the United States Board of Tax Appeals in the *Houghton & Dutton Company v. Commissioner, supra.* In concluding that the loss sustained should be deducted from the income for the entire year, the Board gave these reasons, which appear to be sound:

"* * * Deeply rooted in the Federal tax system is the fundamental idea of computation of taxes on an annual basis. *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359; *Burnet v. Thompson Oil & Gas Co.*, 283 U. S. 301. Even though affiliated with others, each corporation is still a taxpayer, (*Woolford Realty Co., Inc. v. Rose*, 286 U. S. 319), and as such is entitled to have its taxes computed on the basis of its taxable year, which requires that it report all income received within the year as yearly, and not daily, income, and carries with it the correlative right to all the statutory deductions growing out of transactions within the year without regard to the particular day on which they occurred.

"It is argued by respondent that his position here is in accordance with Article 634, Regulations 45, as amended by T. D. 4022 (C. B. VI-1, p. 258) which provides that where two corporations are affiliated at the beginning of the year, but, due to a change in stock ownership or control during the year, affiliation is terminated, a consolidated return shall be filed for the period of affiliation, and a separate return should be filed for each for the remainder of the year. The respondent's theory, if carried into practice, would require the filing of a separate return in cases like this for the fractional part of a day between the close of business on the last day and the end of the year.

"The same provisions appear in subsequent regulations (Art. 634, Reg. 62 and 65), but these later regulations provide further that:

> 'in any case in which the consolidated status is for a period so short as to be negligible, a consolidated return or separate returns for the entire period, as the case may be, may be filed.'

"The respondent's position as asserted here is contrary to the quoted provision which has now been long established.

"We are unable to perceive the necessity of a separate return by the parent company for the period within the year following the termination of affiliation."

The sensible and long-followed administrative custom of disregarding short fractions of a year, embodied in the

regulations cited by the Tax Board, should be decisive if the question were doubtful. But the illogical and unfair results of the fractional year theory—depriving the taxpayer of any real benefit of the deduction—indicate strongly that Congress could never have intended it.

Respectfully submitted,

WARD LOVELESS,
Amicus Curiae.

Washington, D. C.,
December, 1932.